

**THE STATUS OF
HG-I POLICY
COMPONENT**

***With Annex A:
Alternative
Approaches to the
Further
Development of
Housing Finance in
Hungary***

Prepared for

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Abstract

This document is one of a series of periodic reports describing the status of the housing policy component of the 185-HG-I program for Hungary. The policy component includes eight areas on which progress is periodically monitored in order to measure the success of the HG program in Hungary.

As part of this report, a detailed discussion of alternative approaches to the further development of housing finance in Hungary is attached to this report as Annex A. The Annex compares alternative funding mechanisms for housing finance in various European countries and the U.S., and contains potential lessons for Hungary as the government considers different policy options such as contract savings and mortgage bonds.

Executive Summary

The Housing Guaranty Program Agreement signed in May 1994 between the Government of Hungary (GOH) and the Government of the United States describes a program consisting of three components, (1) policy, (2) program lending, and (3) technical assistance. This report comments on the status of the policy component of the Agreement.

The Agreement calls for the best efforts of the GOH to accomplish eight specific policy reforms in the area of housing finance over the term of the program (Annex B of the Agreement). Each of these reforms is reviewed in the following report, noting the accomplishments in each area and the remaining issues.

The GOH Housing Policy Concept speaks about a choice between a "German-style" and an "American-style" secondary mortgage market. The German-style involves the creation of new private lending entities which would issue special bonds to fund their mortgage holdings. The American-style involves the creation of a government-sponsored second-level institution that would issue bonds to fund the purchase of mortgages from banks and other lenders.

Annex A frames the choice between these approaches in the context of what is actually done in Germany, the US, and several other countries. It is concluded that the most successful systems for lending at a variable interest rate (as in Hungary) are private institutions which have access to both deposits and, when desirable for reasons of liquidity or cost-of-funds, bond funds. In effect, commercial banks would normally fund mortgages out of deposits, but have access to a government-sponsored institution for short or medium-term loans against their housing loans. The banks would get the benefit of bond-based funds when it is useful but would not have the competitive disadvantage of having only bond-based funds to rely on. The bond issuer would get the benefit of the good collateral value of the mortgages (as in the German system), without having to deal with the credit risk.

THE STATUS OF HG-I POLICY COMPONENT

#1. Adoption of Housing Policy Statement

A suitable statement of housing policy was adopted by the GOH in May 1993 and published as Resolution 1038/1993. When the new government came in in May 1994, it pursued policies consistent with Resolution 1038/1993. In August 1995, however, the GOH set up a new housing policy advisory body, called the Housing Policy Council, and charged this body with formulating a new set of housing policy guidelines. In July 1996, the formulation and review process was completed and a new Housing Policy Concept was adopted.

The new Concept appears to be more articulate and sophisticated with respect to the goals and tools of housing policy. In fact, it is as clear and "level-headed" as possible for a political document of this nature and should be read in addition to this document. It is also consistent with two of the key goals of the HG, rationalizing housing subsidies and targeting them.

Accompanying the Housing Policy Concept was a set of specific actions requested of various executive bodies, particularly the Ministry of Finance. These are a source of some concern. In particular, the MOF is requested to propose (1) legislation for a mortgage bond; (2) legislation for a Bauspar (contract savings) system; (3) an analysis of a loan guarantee institution; (4) an analysis of a savings and loan-type of institution; (5) technical assistance to local governments on their housing programs; and (6) programs for housing rehab to be adopted by local governments and housing associations, all by 31 August, 1996.

The first concern is simply the timing. The Bauspar and mortgage bond legislations have been gestating for a long while and are at an advanced stage of development. However, all other areas of action are at preliminary stages and a rush to completion may cause errors.

The second concern is that the government is edging toward institutional interventions into housing finance which are inefficient and distortive. This is true to some extent of the Bauspar proposal about to go to the Parliament (more on this under topic #3). More serious is the potential for the government to sponsor a guarantee institution or savings bank that relies excessively on implicit or explicit government guarantees. See the discussion in the report entitled "Alternative Approaches to the Development of housing Finance in Hungary".

In addition to these short term policy actions, the government is directed to conclude the modified HG agreement with USAID and to pursue further the rehab programs supported by PHARE.

Also of interest is the government's stated intent of expanding the potential for property taxes as a source of local revenues and of statistically tracking the housing-related activities of local governments. The Concept states the principle that local housing subsidies based on social criteria will be matched out of state resources.

#2. Implementation of the DPM

The Deferred Payment Mortgage (DPM) was implemented as a major option for borrowers through OTP in March 1994, shortly after the deep repayment subsidies previously offered by the

GOH were ended. At that time OTP chose to portray the DPM as a special option that might be offered to borrowers who OTP branch staff felt were capable of understanding it and meeting the rising (nominal) repayments. Given the suspicions and strongly negative attitudes of the staff, it is relatively surprising that 800 DPM loans were eventually made in 1994, mostly for new housing. This was only 2 percent of all loans made by OTP for the purchase or construction of a house, but 8 percent of the loans for new houses and 11 percent of the total volume of lending for new houses.

There are two special reasons why the DPM is especially preferable for new housing. First, there remains a relatively small interest rate subsidy available to buyers of new houses, such that a certain percent of the outstanding balance is paid off by the government each year for the first fifteen years. The value of this subsidy is larger if the balance on the loan is larger, as it is under the DPM.

Second, a young couple buying a new house, and expecting to have an additional child, can have their loan paid down by the GOH at the time the additional child is born. Until November 1994, this additional amount was only HUF 250,000 for the second child and HUF 600,000 for the third child, but interest on this amount from the time of the loan until the arrival of the child is also paid. Since it was likely that the balance on a non-DPM loan would be less than this amount (plus the accumulated interest), a DPM loan was preferable in these cases. The average size of a DPM on a new house started off much larger because the initial payment rate on the OTP version, 10 percent, was nearly two-thirds lower than the rate on the regular VRM (28 percent).

Two things happened in 1995 to change this situation somewhat. First, an extensive effort was made to change the attitudes of OTP branch staff towards the DPM. Second, the child-related subsidy was raised substantially, making the use of a DPM mandatory for a couple expecting to receive this subsidy at the birth of a child in the future.

The result was a 440 percent increase in 1995 in the use of DPMs by purchasers of new homes, rising to 3200 loans or one-third of all loans made for new houses. Notably, the average size of a DPM for a new house was over twice the amount of the average standard variable rate mortgage. The use of DPMs for existing homes also rose somewhat, by 87 percent, reflecting an increase in the acceptance of the concept. However, the DPM was used by less than one out a hundred buyers of an existing home (partly because several adverse underwriting standards employed by OTP keeps the advantage in terms of loan amount to less than 50 percent more than a conventional mortgage design, in contrast to DPM loans for new houses). In total, DPMs constituted about 23 percent of the volume of OTP's lending for home purchases in 1995.

So far in 1996, overall lending by OTP has fallen off sharply due to higher real interest rates and a decline in construction activity over 1995 levels. The use of DPMs by builders of new homes has remained at about one-third. There continues to be a small uptrend in the share of purchasers of existing houses using a DPM.

#3. Reforming GOH Housing Finance Subsidies

There have been dramatic changes since 1993 with respect to GOH housing subsidy policy. As required under the HG agreement, mortgage subsidies were drastically reduced as of the beginning of 1994; loans for existing homes and most types of rehabilitation lost all subsidy and the subsidy for new houses was halved. The child-related lump-sum subsidy remained available for new housing. Meanwhile, the previous exclusion of housing from the 25 percent Value Added Tax was partially removed in early 1993 and then fully removed as of December 1994.

At the time of the termination of any exclusion of new houses from the VAT, the GOH attempted to recycle the funds raised from the VAT on housing into an expanded child-related lump-sum subsidy for new houses. The decision to focus nearly all of the subsidy on the second and third child caused these incremental subsidies to soar to HUF 1 million, a large sum relative to the cost of a house. The complex set of effects of this shift were explored in reports in July 1995 and February 1996.

One of the most notable aspects of this new version of the Social Policy Allowance, renamed the Housing Construction Allowance (HCA), is that it worked as lump-sum subsidies are supposed to. The beneficiaries could clearly see the benefits and reacted accordingly; the GOH was cognizant of the full cost of the subsidy and also acted relatively swiftly. The result was that the subsidy was extremely popular but was significantly truncated in May 1995 due to its significant cost to the GOH. It should be noted, though, that because of the way eligibility for the subsidy was defined, high levels of expenditures under the HCA are expected to continue through 1996 and into 1997.

The methods of truncation were notable. First, the limits on the cost of an eligible house were reduced enough to target it to moderate income households (depending on how effectively potential beneficiaries defeat the intent of these limits). Second, the HCA was limited to those who had not previously received a social-policy housing subsidy. This should effectively limit it to first-time buyers (unfortunately, though, only to first-time buyers of new homes).

The experience with the HCA was a good illustration for the GOH of several features of counter-cyclical housing policy. First, such policies can be very expensive in total expenditures, because it is difficult to know how people will respond to a new deep subsidy. Secondly, such subsidies are usually very expensive relative to the amount of extra activity generated. It is now estimated that the extra cost of the HCA was about HUF 3 million per unit for the 10,000 extra units estimated to have been started in 1995, probably half of the average cost of a unit. This is also because it is difficult to focus the subsidy only on those at the margin of entering the market and not on those who would have built anyway.

The government now expects the HCA to remain as it is for the foreseeable future, with the intent that inflation reduce over time the real value of it. Although this freezing of the subsidy in nominal terms will free up budgetary resources over time, these resources are apparently to be used in other housing-related subsidy schemes. The government has indicated that it expects to maintain the share of housing subsidies in the budget at 4 percent, down a bit from the current range around 5 percent, but at the top of the norms for the EU of 2-4 percent.

Towards that end, the GOH is proposing to the Parliament a major new subsidy program, through support of German-style Bausparkasse. The proposed subsidy is for a match of up to 30 percent of qualifying savings, on up to HUF 120,000 a year in savings. Such a subsidy is in principle better than some other common subsidies, including the HCA as currently designed, because it can be used more broadly for purchases of existing houses and for rehabilitation and additions. However, it will tend to be regressively distributed, not only because higher-income household will be more likely to receive the maximum subsidy per person, but also parents can also save in a Bauspar and the benefit of the low-rate loan be passed on to a child. Upper-income couples with upper-income parents will easily be able to get HUF 144,000 a year in subsidy for 4 years before buying a house.

Although the Bauspar approach is better than some subsidies, it is far from perfect. It boils down to a state subsidy of the interest on savings so the Bauspar can offer low rates on loans, i.e., it is a form of subsidized loan. Its small advantage over a subsidized loan is that it requires a certain amount of savings. However, buying a house in Hungary involves a large amount of savings anyway, so it is unlikely that this will mean more savings. Its big advantage over some other subsidies is that the (indirectly) subsidized loan can be used for any housing-related purpose, including rehabilitation. On net, however, it is not obvious how the Bauspar system is advantageous over the previous system of subsidized loans. And it is definitely inferior to targeted lump-sum grants (see below).

If the Bauspar approach is pursued, along with the related expansion in loan subsidies, consolation can be taken in the fact that it may engender increased interest in lending not only under the contract savings plans, but also for additional loans to complement the Bauspar loan. This situation may go far towards addressing issue #8 below, competition with OTP.

Unless the Bauspar subsidy expenditures are much larger than expected (which they may easily be), there will be significant potential for creation of new housing subsidy programs in 1997 and beyond. The subsidies under the truncated HCA should fall to less than 10 billion in 1997, the subsidies on the loans originated prior to 1989 should fall off sharply if interest rates come down, and the payment subsidies on loans originated between 1989 and 1993 should also begin declining in 1997.

The Housing Concept seems to foresee an expansion of subsidies towards young married couples, rehabilitation, and "social purposes." It appears that the young couples subsidy would be lump-sum, only partly dependent on buying a new house (in contrast to the HCA), and be loosely means-tested through a required match from local governments that would presumably involve a needs-test of some kind by the local government. The rehab subsidy is not defined. The "social purposes" subsidy seems to be an expansion of the current block grant for housing to local governments. It is not clear whether action will be taken in this regard in the 1997 budget or await the 1998 one. It appears that this point, though, that such subsidies may be superior to most if not all the existing programs.

#4. Actions to Reduce Credit Risk

Significant actions were taken in 1993, 1994, and 1995 in this area. The Rental Act of 1993 made it relatively easy to evict tenants, including those who became tenants by virtue of

being foreclosed upon. Legislation on court procedures in 1994 introduced the possibility of obtaining "notarized" mortgages which could be foreclosed upon without normal court contestation. Thus, loans originated since 1994 could be subject to a legal framework that is fairly supportive of the access of housing lenders to the housing collateral. Additional reforms enacted in May of 1996 have further expedited the potential process.

A consultant has recently reviewed the overall effectiveness of the new procedures. It appears that OTP has not moved aggressively to utilize its new powers; in fact, it continues to not notarize mortgages. Thus, nothing has changed with respect to its ability to foreclose. OTP gives two reasons for its behavior. First, it claims that the cost of notarization, as set by the Government, is about 5-10 percent of the amount of the loan. (This needs to be independently verified.) If so, it is critical that this charge be rationalized.

Second, OTP seems to think that it is doing alright under its alternative procedures. In other words, it is comfortable relying on other collateral and also guarantors for recoveries, as well as a system of ad hoc rescheduling of loan repayments.

This latter assertion may be true today, but there was some presumptive evidence against it earlier. (Delinquent loans must now be written off according to international accounting practices and thus OTP may be taking stronger action in this area.) The rates of delinquency as of January 1, 1994 on loans made from 1989-1993 were simply horrible and indicated a steady decline in recoveries as loans age, with more and more loans becoming overdue by more than one year and few of these again becoming current. More research needs to be done on the factual basis of OTP's claims before it can be concluded that further action is not needed in this area.

From earlier comments by OTP and potential competitors, they seem to view foreclosure and sale as simply not a viable option in most cases, no matter what the costs or procedures. To a great extent, this same view permeates mortgage lending in other European countries (but not so much the U.K.). Some other countries have evolved other systems to finesse the situation. For example, the social support system for poor or unemployed in Germany provides extra support for keeping up mortgage payments. France has evolved a 30-month hearing and negotiation process that is costly (and reflected in loan rates) but relatively reliable as to the outcome. In all cases, the bedrock of the system is certainty of the inevitability of foreclosure and eviction if the borrower is recalcitrant. It is still necessary to achieve such a presumption on the part of borrowers in Hungary.

Perhaps to avoid having to come to grips with this problem, it has been commented in other contexts that some entity sponsored by the government could take over the execution of defaulted mortgages. This seem to be what the Government is contemplating doing in the future and has asked the MOF for a proposal on at the end of August. This could possibly be the "Hungarian" equivalent of the finessing done in other European countries, but will be sustainable only if built on a framework of effective foreclosure, actuarially-sound fees, and insulation from political pressures. TA should be provided in this area to the extent possible.

#5. Sounder Lending Practices

This is more of a goal of the TA component than of the policy component of the HG program. However, it is worth noting that, in adapting the DPM to its perspectives, OTP did explicitly evaluate the greater risks involved in the loan and specify more conservative underwriting criteria for it. In general, OTP has proceeded with lending during the transition period cautiously, fully aware that its previous favored position for loan recovery through wage garnishment has ended. Moreover, banking regulators are now requiring proper write-offs for delinquent loans, giving OTP full incentives to employ sound underwriting and delinquency management techniques.

One area of uncertainty here is the accounting treatment of the deferred interest on the DPMs. It used to be that OTP's accountants were requiring that the unpaid interest be written off fully as loss until it is paid. This is unreasonable and makes the DPM less desirable. There is an indication in an OTP document that this rule may have been changed. This should be determined next time.

#6. Credit Enhancement Structure

Developments in this area are in flux, given the Government's stated intention to consider creating a "loan guarantee institution". As noted above under item #4, there are a number of significant concerns in this respect.

#7. Accessing Long-Term Funds

Developments in this area are also in flux, given the Government's stated intention to consider creating a secondary market institution of some kind. Previous discussion had focused on allowing private mortgage banks to develop, but now seems to include the potential for a single Government-sponsored institution to be developed. The issues with respect to this are discussed in Annex A, entitled "Alternative Approaches to the Further Development of Housing Finance in Hungary".

If in fact the government plans to move rapidly in this area, it would probably be very important to monitor developments more frequently and seek to be a participant in the discussions in this regard. The experience with the Bauspar proposal was that there was background discussion going on for a while (for which we provided cautionary TA), but when a specific proposal surfaced, support for it was already solidified.

#8. Encourage Competition with OTP

The process of bank privatization and revitalization seems to have accelerated recently, with the purchase of controlling interests by foreigners in some cases and the sale of most of OTP to the general market. There seems to be some perception that domestic banks have a competitive disadvantage in lending to the safer commercial entities in Hungary and thus the domestic banks may be developing a greater interest in pursuing an area where they should have an advantage, consumer lending, including for housing. Greater interest in this area would be beneficial for every aspect of the housing finance market.

The other banks, however, frequently indicate concern about the dominant position of OTP in the retail deposit market. In fact, without access to a stable base of relatively low-cost deposits, it is difficult to see how any bank can mount a sustained assault on OTP's position in mortgage lending. In this regard, several banks are working on schemes to attract more retail accounts. But they also evince the belief that, just with the ability to offer Bauspar accounts and to offer mortgage bonds, they will be able to compete. This goes against the seeming fact that both of these other businesses involve interfaces with households and that, until such interfaces have been developed, OTP is likely to dominate these kinds of businesses as well (as has happened in Slovakia under similar circumstances.)

Along these same lines, there have been indications in OTP's annual reports and elsewhere that the threat of competition, preceding actual competition, is driving OTP's strategy in the retail sector. OTP appears to be making a concerted effort to improve service and recently has even started to seriously cut costs to better "prepare for battle" over their deposit base. This probably also applies to housing loans to some extent, at least with respect to service and choice. But in the absence of serious competition, OTP has no incentive to trim their margin on housing loans. Indeed, they have every incentive to keep it large, because it affects the subsidies they receive on the large block of old loans that they hold. Thus, there appears to be some potential for another lender to enter the market, whether funded through deposits or mortgage bonds.

Annex A

ALTERNATIVE APPROACHES TO THE FURTHER DEVELOPMENT OF HOUSING FINANCE IN HUNGARY

Executive Summary

The Housing Policy Concept speaks about a choice between a "German-style" and an "American-style" secondary mortgage market. The German-style involves the creation of new private lending entities which would issue special bonds to fund their mortgage holdings. The American-style involves the creation of a government-sponsored second-level institution that would issue bonds to fund the purchase of mortgages from banks and other lenders.

This report frames the choice between these approaches in the context of what is actually done in Germany, the US, and several other countries. It is concluded that the most successful systems for lending at a variable interest rate (as in Hungary) are private institutions which have access to both deposits and, when desirable for reasons of liquidity or cost-of-funds, bond funds. In effect, commercial banks would normally fund mortgages out of deposits, but have access to a government-sponsored institution for short or medium-term loans against their housing loans. The banks would get the benefit of bond-based funds when it is useful but would not have the competitive disadvantage of having only bond-based funds to rely on. The bond issuer would get the benefit of the good collateral value of the mortgages (as in the German system), without having to deal with the credit risk.

Thus, it is suggested that, if the Government wants to get involved in facilitating the funding of mortgages, it sponsor a Housing Fund that issues bonds (guaranteed or not) and uses the funds to make unsubsidized loans against pools of qualified mortgage collateral. In doing so, Hungary would be consistent with the worldwide movement towards integrated, unsubsidized financial systems.

ALTERNATIVE APPROACHES TO THE FURTHER DEVELOPMENT OF HOUSING FINANCE IN HUNGARY

BACKGROUND

The transition of the housing finance sector is keeping pace with the transformation of the Hungarian economy and society. The tradition of deep subsidy has ended and the tools have been put in place for competitive origination and effective recovery of long-term housing loans. The banking sector has been strengthened and subjected to rigorous standards of accounting and accountability. Yet, the volume of lending is at very low levels and OTP continues to face little competition in this market. The question has been raised by the Government's new Housing Policy Concept as to whether additional institutional development is needed in the sector.

In particular, the Concept calls for a study of potential developments in two areas, (1) access to long-term funds and (2) a guarantee institution. It goes on to mention two options for accessing long-term funds, including German-style mortgage banking or a central mortgage fund capable of refinancing mortgages from issuances of securities. To facilitate this process and to encourage loan originations, it further suggests, within the area of potential subsidy, a loan guarantee or insurance option.

These suggestions raise many basic questions about the future shape of housing finance and especially the role of the government. This paper is intended to be a contribution to this discussion, with a focus on what can be learned from how other countries have addressed these issues.

ALTERNATIVE FUNDING MECHANISMS

The countries of the world use a wide range of approaches to housing finance. It might be expected that only one or two of these would be truly most efficient and would be used in most developed countries. In fact, practically no two countries seem to share the same funding pattern. Particularly in the past, most financial systems developed special mechanisms for raising funds or lending for housing. The choice of mechanism not only reflected the preferences of the borrowers and investors (or depositors) in that country, but also a variety of political, social or historical considerations.

However, for the last twenty years, economic forces have been pushing systems towards much greater uniformity. In the US, UK, and France, commercial banks have been freed from restrictions on their mortgage lending and have become major participants. At the same time, traditional housing lenders such as savings banks have been given the powers formerly reserved for the commercial banks. Both of these types of depository institutions have had to compete with money market funds for the current and savings deposits of households and, at the same time, have gained access to more ready supplies of "wholesale" institutional funds dispensed by these new intermediaries. The bond markets have developed channels for funds to banks and other depository institutions for purchase or refinance of assets, and institutions such as pension plans, investment funds, and personal retirement accounts have been the recipients of a growing share of personal savings.

Not all of these forces are coming to play immediately in Hungary nor is the starting point here the same as many of these other countries. However, it is reasonable to expect that Hungary will not be immune to these forces, especially as the transition matures, and it should be useful to consider what has been the case in other developed countries and how those systems are developing now.

Denmark.¹ The Danish system is one of the most extreme with respect to its specialization of purpose and conventionality of structure. Most Danish mortgages are made by mortgage banks. They are at fixed rates, for up to 80 percent of appraised value, generally amortized over 20-30 years and, because of low mobility in Denmark, have a relatively low rate of prepayment and thus a long duration. They are permanently funded by mortgage bonds issued at fixed rates and callable according to principle repayments, whether scheduled or prepayments.

This system provides over 80 percent of all housing finance. The system has been in effect for over 100 years and is only beginning to feel the pressures for change.² Why not start a similar system in Hungary? There are several reasons this probably would not be feasible in Hungary. First, Denmark has long-established pension and insurance companies that are interested in long-term fixed rate bonds and have been, in fact, required to hold such bonds, to the detriment somewhat of their beneficiaries. Moreover, the Danish government traditionally issued little long-term debt that might compete.

Second, the security of the bonds rests on two features, (1) easy foreclosure procedures and (2) the joint and several liability of all borrowers. In other words, all of the borrowers promise to make up any deficiency created by shortfalls in foreclosure proceeds (in excess of the mortgage bank's capital). Moreover, Denmark has generous unemployment benefits and other social supports that helps reduce the number of loans going to foreclosure.

It should be noted that commercial banks in Denmark are also involved in mortgage lending, but primarily for the amount in excess of 80 percent of the appraised value. Such lending is unlikely in the near term in Hungary because incomes are low relative to house prices. Since these loans are funded out of deposits, the rate is variable.

Germany. The French claim to have invented the mortgage bond (Credit Foncier in the 1850s), but Germany, Austria, and the Scandinavian countries soon began to rely on it to a greater extent. Such mortgage banking is today called "German-style," but in fact provides only about 22 percent of German housing finance. Nor is it as simple as the Danish system. Loans are up to 30 years in term, but have rates fixed for only 3-10 years. They are funded by bonds with terms only for the period that the rate is set. In other words, even German mortgage banks do not match-fund with respect to maturity.

¹ The discussion in this section is drawn from a monograph published by Fannie Mae, "Housing Finance in Developed Countries: An International Comparison," by Douglas B. Diamond and Michael J. Lea, 1992.

² There have been discussions of mergers between mortgage banks and commercial banks or commercial banks setting up their own mortgage banks. The author does not know the current status.

Why do not the Germans use the Danish system? There is no simple answer. Partly there is not a major market for really long-term bonds. Partly the Germans rely on a low loan-to-value (LTV) ratio (maximum of 55 percent) to limit risk, rather than joint liability. The surprising fact, though, is that Germany actually utilizes more heavily loans from savings banks than from any other source (even the Bausparkasse hold only about 10 percent of the mortgage assets), presumably reflecting a rate advantage for these institutions over the mortgage banks. (The savings banks are generally government owned and thus have access to deposits and wholesale funds at favorable rates. They also have access to longer term liquidity from their regional central banks (the Landesbanken), which may issue secured or unsecured bonds.)

There are still other players in the German housing finance system. Small credit cooperatives hold about 10 percent of mortgage debt, funded mostly by members' deposits, with liquidity backup access to a special central bank which can issue bonds. The big commercial banks also issue mortgages. Most importantly, today they or a savings bank are the primary contact point for the customer, where they can get a Bauspar loan, a mortgage bank loan or savings bank loan, and also a "top-up" loan, all from affiliated institutions.³

How is credit risk managed? As in Denmark, there are clear rights of foreclosure and there is no mortgage insurance, but there is a generous unemployment support system, and even an extra allowance for some low-income households to make mortgage payments.

Can the German mortgage bond system be adapted to Hungary? Perhaps, since there is already evidence that bonds with terms to maturity of 3-5 years can be sold. One major caveat is that no bonds with rates fixed beyond 1 year are likely to be saleable in the near future. Thus, the mortgages will have to have variable rates similar to those issued by OTP currently. The second major caveat is that Hungary is not rich enough to provide a social safety net that buffers loan repayments from economic difficulties (nor may it ever want to provide such a generous net).

It is notable, though, that the largest type of lender in Germany, the savings banks, operates not unlike the largest lender in Hungary, OTP, primarily making variable rate mortgages funded out of retail deposits. In fact, it can be argued that the special German lending institutions, the mortgage banks and the Bausparkasse, are artifacts of the historical development of German housing finance and would not arise today without special assistance. This case becomes clearer after we examine the other systems.

France. The mortgage bond system disappeared in France, but today there are mortgage banks drawing upon wholesale sources in unsecured fashions and regular banks of all kinds (commercial, mutual, and savings) drawing upon deposits and contract-savings funds. The regular banks dominate the sector, primarily because of the advantage they have of cheap funds gathered through current accounts and the heavily-subsidized contract-savings scheme (which provides half the funds for their mortgage lending). There have been recent attempts at

³ The net effect is that, even though the German system may appear very segmented, it is consolidating along the lines of the US, UK, and French system, with a bank at the center and pulling funding from whatever is the cheapest source.

securitizing mortgages truly in the American mode (as a "sale-of-asset"), partly to reduce capital requirements and partly because most mortgages are at fixed rates and there is a desire to eliminate the interest rate risk. But it was found that, after all the costs of doing so, the cost of securitized funds was so much higher than the cost of deposits that banks were not interested.⁴

Credit risk has some special features in France, ones that may be instructive for Hungary. It has been accepted traditionally in France that lenders would not look primarily to the house as security for the loan. First, loans were generally only made to established customers of banks, and as part of an ongoing relationship. Second, there were serious regulatory barriers to foreclosure, mandating a 30-month period to completion, compounded by some major taxes and other expenses. Because of this, lenders did not even complete an appraisal of the market value of the property.

The 1980s brought rapid changes in the banking sector and to the economy. Banks began competing for retail accounts, including mortgage lending. At the same time, structural unemployment began to rise and an additional layer of regulatory barriers to foreclosure was created. The end result has been very high levels of default (5 percent of outstanding loans in 1990) and rising provisions. Notably, though, completed foreclosure remains rare; it is too expensive and time consuming for both parties. However, it appears that the strong negotiating position of the borrower encourages delinquency and default and causes lenders to renegotiate loans on favorable terms to the borrower. The end result appears to be more costly loans for all the other borrowers.

Since 1966, there has been an option for lenders to obtain long-term refinance for mortgages. The current version, the Caisse de Refinancement de Hypothecaire (CRH), sells bonds (not government-guaranteed) and passes the funds to the banks through bullet loans for 10-12 years, collateralized by amortizing mortgages of a typical term of 15 years. It is in principle a potential liquidity window for banks and mortgage banks, but, partly because of the relative scarcity of long-term investors in France, its cost of funds have not been attractive to most lenders.

United States. Housing finance in the U.S. is both famous and frequently misunderstood. For most of the period after the Great Depression, most lending was done by savings and loan institutions and savings banks. Because there was a presumption that institutions focused on relatively stable savings deposits could better support long-term mortgage lending, a combination of regulatory barriers to commercial banks lending and tax and regulatory advantages to savings institutions gave the latter most of the market. Oddly enough, though, the average term before the Depression was only 12 years for savings institutions and yet savings institutions still failed widely for liquidity reasons in the banking panics of the period.⁵

⁴ It was also found to be more complex than expected to create the necessary legal structure in the Civil Code, which lacks the flexibility of Anglo-Saxon law in this respect. On the other hand, the experience there would probably be very useful if Hungary were to attempt the same thing.

⁵ A mortgage bond market had developed for a while at the end of the 19th century, but was never properly regulated and fell into disrepute.

Two steps taken during the Depression greatly reduced liquidity concerns, (1) the introduction of deposit insurance and (2) the creation of a special government sponsored liquidity window, the Federal Home Loan Banks (FHLBs). The FHLBs stood ready to provide short and medium term "advances" to institutions based on qualifying mortgage collateral and were able to issue bonds to finance these advances at advantageous rates, both because of the low credit risks of the collateralized loans and because of the government sponsorship of the FHLBs (which were technically private, owned by the institutions).

It was also during the Depression that the seed for the modern US secondary market was planted. The Federal Housing Administration was set up to insure long-term loans (originally 20 years), after the failure of prior private mortgage insurers. The shift of credit risks to the government set the stage for a government-sponsored conduit for funding. Soon thereafter a second agency, the Federal National Mortgage Agency (Fannie Mae) was set up to buy FHA-insured mortgages with government-guaranteed debt and later created a pass-through arrangement whereby the pools of loans themselves were sold to investors with a blanket guarantee.

The existence of Fannie Mae allowed for the growth of American-style mortgage bankers, who originated loans solely for quick sale to Fannie Mae. However, despite Fannie Mae being split into public (Ginnie Mae buying FHA loans) and private (Fannie Mae) portions and Freddie Mac being established to buy loans from savings institutions, the role of the secondary market was not very significant before the 1980s. In general, savings institutions did not feel that the interest rate and liquidity risks that they were bearing were severe enough to warrant the costs of the secondary market.

Eventually, the interest rate risks of lending at fixed rates out of variable rate sources of funds (as earlier required by law) destroyed many of the savings institutions and powered the rise of the secondary markets. (In the process, the distinctions between savings institutions and commercial banks were eliminated.) The result today is that depository institutions avoid holding fixed-rate loans and sell most of them to the three government-sponsored institutions. But it is important to note that they play a relatively small role in the funding of variable rate mortgages. The lenders find that a combination of deposit funding and access to advances from the FHLBs is preferable.

Two other aspects of U.S. housing finance are worth noting. First, because of the high mobility rates in the U.S. (about 20-25 percent of all households move each year), the effective term of most home loans is much less than the stated 30 year term. The working assumption for most loans is an average term to final payment of 12 years, in contrast to 18 years in Germany and closer to the effective life of the 15 year loans commonly made in France. Second, the U.S. has the greatest reliance on foreclosure as a tool for loan recovery. For example, almost half of the loans that become delinquent more than 60 days go to foreclosure. In contrast, the foreclosure rate in Denmark was only one-tenth that of the rate of delinquencies over 6 months in 1990.

United Kingdom. In the 1980s, British housing finance has passed into a deregulated state seemingly quite different from the U.S., but actually more similar than it seems. As in the

U.S., the home lending sector had been the restricted preserve of the savings institutions. Then commercial banks were permitted entry and in certain years took more than one-third of the market. Later in the decade, "centralized lenders" perfected a technique for securitizing loans and took another 13 percent, leaving building societies as little as half the market.

Since 1988, the securitized lenders have retreated under the burden of higher wholesale funding costs relative to deposits and increased costs for the (private) mortgage and pool insurance coverages needed for securitization. That has left the depositories, primarily the building societies with their traditionally cheaper deposit base, with 90 percent of the market.

Why has securitization taken over the American market but not in the UK? Much of the answer lies in the fact that Britain had bouts of inflation as early as the 1960s and made the transition to variable rate loans at that time. Despite the recent appearance of some fixed rate lending (or rates set at least for several years at a time), the great majority of lending is what is called "reviewable-rate" with a term of 20-25 years. The rate is subject to resetting by the lender at any time, with the borrower having the prerogative to prepay and borrow elsewhere.

As in the US, such variable rate debt is not as attractive as fixed rate paper to long-term institutional investors. Nor does it pose the problem of interest rate risk that drives depository lenders to sell their mortgages in the US. So, just as in the US, there is a tendency for depositories in the UK to fund their variable rate loans out of deposits. However, the bond market is not ignored by the sector entirely. In addition to the mortgage-backed securities sold by the centralized lenders, the depositories raise about 20 percent of their funds through unsecured floating rate notes or fixed rate bonds which they swap into floating rates. They do this without credit enhancement or insurance, simply based on their credit history, capital, and quality of supervision. As market forces affect the spread between the costs of deposits and wholesale funds over time, the lenders take advantage accordingly.

Credit risk has been a major issue in the last ten years. The growth of the centralized lenders relied on the willingness of private insurance companies to provide blanket insurance on the securities. Unfortunately, a steep runup in house prices from 1985-89 left the insurers exposed to massive losses in the ensuing down market. Some of the companies have continued to offer such insurance, but only at higher rates. As some of the insurance companies saw their credit ratings decline, so did the rating of the securities insured by them, boosting the risk spread on all such securitization. The American secondary market has been immune to such a problem, because of the implicit backing of the government.

POTENTIAL LESSONS FOR HUNGARY

A careful review of trends in institutional developments in these countries indicates that, while their traditional structures have featured specialized channels for funds for housing loans, most have been moving away from such specialization. This is easily seen in the US and UK, where almost all distinctions between savings institutions and commercial banks have been removed, and both make housing and commercial loans today. But it can best be seen in the case of one of the most officially segmented housing finance systems in the world, Germany. Traditionally, the Bauspar and mortgage banks were separate entities far removed from the

corporate finance activities of the big commercial banks. However, today in the era of Allfinanz⁶, the commercial banks are more retail-oriented and have integrated the functions of affiliated Bausparkasse and mortgage banks into the package of services they sell. Also, commercial banks and savings banks tap into bond markets at rates almost as low as the mortgage banks, reducing the advantage to the traditional mortgage bank concept.

Many observers consider the market in the UK to be indicative of what a "natural" market, without government intervention, would tend to look like today. There is little distinction between savings institutions and commercial banks, both make housing loans on similar terms and both use a combination of wholesale and deposit funding. There are also private companies raising funds by securitising loans (based on private insurance) and winning those parts of the market looking for loans of a type well-matched to what bond-holders are looking to hold. But these companies do not have the flexibility of the depositories to shift fund-raising activities as market conditions change.

Most importantly, it should be noted that there is relatively little concern anywhere about relying on mortgage funding that is for a term shorter than the term of the loan. The statement in the Housing Concept that "long-term loans require long-term sources of funds" has some truth to it, but much less than it once did. Only the Danish bond market and the US secondary market provide funding for the full term of a mortgage, and only in the case of fixed-rate loans. The term-mismatch has been addressed in some systems (US, France, Germany) by liquidity windows to be used by depositories on an as-needed basis. All systems have deposit insurance to deter bank runs. Some have also relied on depositories having good access to wholesale funding to supplement deposits as cost and availability dictate.

Thus, the Hungarian situation bears some further examination to clarify why there is interest in creating special access to the bond market, through mortgage bonds or a housing fund. The fact is that OTP is happy operating in much the same manner as the major variable rate lenders in Germany, France, the UK and the US, i.e., funding long-term loans out of deposits.⁷ (Admittedly, the duration of OTP's loans is effectively quite short at interest rates of 25-30 percent. If interest rates are substantially lower in 2-3 years, then the duration will be much longer.)

Non-intervention. In this sense, will not the Hungarian market naturally develop in the new British fashion, with banks funding most lending out of deposits? Unfortunately, the British system presumes a well-developed deposit market, in which a number of depositories have access to stable supplies of deposits. The most important difference in Hungary is the starting point, whereby OTP dominates retail banking. This gives OTP advantages that can help it

⁶ "Allfinanz" is the German term for the "radical" notion that one organization could meet all of a customer's financial needs, from a Bauspar mortgage to insurance, etc.

⁷ It should be noted that it is in the nature of "reviewable-rate" mortgages that banks can adjust rates to cover whatever they have to pay for deposits and, if the rate gets too high, the term of mortgages is automatically truncated by people prepaying and borrowing elsewhere. Thus, the liquidity risks of such lending are primarily only of a short-term nature, not associated with longer-term changes in the funding situation at a bank.

preserve its position, and it can be argued that it is necessary to open up new channels of funding to potential competitors to break up this monopoly position.⁸

Thus, one view is that it is necessary to consider some system whereby depositories can avoid the need to develop a deeper deposit market by accessing the capital markets directly. As noted, that takes place in all of these other countries through banks offering short and medium term unsecured debt or through a liquidity facility. Presumably this will happen eventually here also, but the state of the banking sector at the moment makes it unlikely that it will happen any time soon. However, it should be noted that creating a special channel just for housing finance will not solve the more general problem of developing the deposit base of funds for all other purposes.

The situation could also be affected by the introduction of Bauspar-type savings contracts. These subsidized savings accounts can be offered by any bank, through a separate subsidiary. However, it is possible that the Bauspar accounts may actually improve OTP's position. It is not clear that other banks which are not capable of both raising retail deposits and making retail loans in general will do very well with Bauspar contracts. Moreover, OTP may be able to offer the additional advantage of paying off existing loans automatically when one takes out a Bauspar loan.

Mortgage Bonds. Thus, there is a great interest in other alternatives. One that has been under consideration for several years is to provide the legal and regulatory infrastructure for a German-style mortgage bond. This structure would allow banks to create mortgage-banking subsidiaries which, in theory, could raise funds on the bond market for mortgages (and municipal lending) at low rates. This is, in principle, an attractive route, because it allows private lenders to arrange their institutional structure in such a manner as to create an extra safe portion of the bank to access the bond market on better terms.⁹

There are at least two challenges that must be resolved for this approach to work, however. First, the low-risk of a mortgage bank derives from low credit risk and low interest rate risk. The latter requires a careful matching of the terms of the mortgages with those of the bonds. Thus, if the only kind of bonds that can be issued are either floating-rate at some premium over Treasury bill rates or fixed-rate for two years, then that is what the mortgages must be structured as, probably without prepayment options in the case of the fixed-rate funding. The mortgage bank will probably not be able to offer loans with fixed rates nor will it have the flexibility of having a diversified range of funding options and mortgage design options that a bank has.

⁸ It is sometimes suggested that if the state created a monopoly on retail deposits, it can also end it by breaking up OTP into competing units. Presumably, there is not much support for this, though, from the other existing banks, who do not want even more competition. Of course, there are also many practical problems associated with this approach.

⁹ The presumption here is that primarily commercial banks will set up mortgage bank affiliates, rather than there be wholly new separate institutions. In other words, the mortgage system will skip the stage of the German-system where mortgage banks were totally independent entities with a separate network of lending offices and start at the point Germany is at now, where most mortgage banks are integrated with commercial banks.

The second difficulty is that, in Hungary, a mortgage bank structure does not, by itself, make the mortgage bonds as safe as they are in Germany. In Germany, the bonds are made a safe investment by restricting the bank to making only those housing loans which clearly have very low credit risk, i.e., with loan-to-value ratios of 55 percent or less. In Hungary at this point in time, there is not a track record of effective recovery on delinquent mortgages to show that such low "exposure" loans are nearly riskless.

Does this mean that there is no point to creating the ability for mortgage bonds to be offered? Not at all. Presumably the credit risk problem for housing loans in Hungary will be solved eventually and is thus not a permanent barrier. Also lower and stable inflation may make it possible to offer bonds with rates fixed for five years. Thus, mortgage banks may be successful in the future. Even so, the intrinsic inflexibility of such funding may prevent it from being successful or from maintaining market share in the future relative to deposit-based institutions. What these arguments do suggest are that it is inappropriate to enshrine in Hungarian law any special advantages, including subsidies, of mortgage banks over other funding and lending arrangements.¹⁰ They should have to prove their superiority or be allowed to fade away.

Housing Bond Fund. A second approach to creating new channels for mortgage funding is for the government to sponsor a bond-funded window for lenders to sell their mortgages to. Part of the attraction for this approach is that it substitutes a government guarantee for bond buyers for the protective, but cumbersome, structure of the mortgage banks. In general, however, reliance on a government guarantee is not a good idea, both because it could expose the government to substantial losses and because it can give certain kinds of lending advantages over other forms and thus distort the flow of capital in the economy.

Other advantages of this approach are also significant, including permitting larger scale bond issuances and potentially more flexibility in mortgage offerings.

The foremost version of this approach is that Fannie Mae, the trillion-dollar secondary market institution in the U.S. Fannie Mae purchases primarily fixed-rate bonds and then sells the rights to the cash-flows from pools of such bonds. In theory, these "pass-through" securities would end up bearing whatever risks are associated with the underlying mortgages, but instead Fannie Mae guarantees against credit risk on the pools, with a back-up of private mortgage insurance on the portions of loans in excess of 80 percent LTV. The major risk that the bond buyers take is uncertainty as to whether the borrowers will prepay their loans and thus what the real duration of the security is. This risk is primarily associated with fixed-rate loans, and lenders and Fannie Mae want to pass it on to investors who are in a better position to manage it.

Would a Fannie Mae arrangement, call it a Housing Bond Fund, work well for Hungary? The answer depends on several issues. Where would the credit risk on mortgages end up, with the Housing Fund or the lender or an insurance company? Can a Fund sell bonds at a rate that would compete with the cost of deposits? Would these terms be similar to those on the types

¹⁰ In this regard, it is notable that mortgage banks are struggling to get established in the Czech Republic and Slovakia and are receiving or seeking special subsidies to do so.

of mortgages that borrowers want? Is there any chance that investors would be interested in "pass-through" securities?

To this observer, the answers appear to be the following. First, the credit risk must stay with the lender or be shifted to an insurance company. The Housing Fund is not in a good position to effectively evaluate or manage it, especially when loan recovery is still not a settled area. Second, it is unlikely that the Fund would have an all-in cost of funds less than the cost of deposits in the current market. Deposit rates are probably lower than they should be because they are not very effectively competed for yet. Bond funding costs will be higher than expected because there are not that many bond investors.¹¹

However, if inflation stabilized at a level allowing longer-term fixed rate debt, then this may be advantageous over deposits, at least if borrowers preferred the certainty of fixed rate mortgages and lenders wanted to avoid interest rate risk. Variable rate and DPM-type mortgages are probably cheaper to fund with deposits.

Lastly, it is unlikely that the market would be able to evaluate a "pass-through" security anytime in the near future.

Thus, it appears that a Fannie Mae-type institution may not necessarily generate attractive funding either. That seems to leave the situation where it was, with the depositories expected to fund their own mortgages through deposits or debt based on their own credit rating.

That brings us back to the problem of spreading the deposit base among all of the banks. In this regard, it should be recognized that this problem will continue to plague the banking system even if a bond-funded channel is created for housing loans. Thus, it is not really the central issue here. It must be resolved for the sake of the entire banking sector, not just housing.

A SECONDARY MARKET FACILITY

Both a Housing Bond Fund and the mortgage banks are designed to create alternative channels for funding aside from deposits. Yet depositories, once they have developed better deposit bases, should be the best vehicle for home lending, at least of the variable rate type. There is one approach, however, which may be consistent, not competing, with banks developing larger deposit bases and yet also reduces the liquidity risks of mortgage lending and gives banks greater access to the bond market.

¹¹ The bond market in Hungary has developed greatly in the last few years, because of the huge flow of government debt. In fact, it has drawn significant resources away from the deposit market. Moreover, the expected growth in private pension funds may assure a much better bond market. It is also possible in the future that bonds issued by a Housing Fund could be sold on foreign markets, thereby broadening the supply of investors. However, both Britain and the US have excellent bond markets and yet variable rate loans are mostly funded out of deposits.

Most of the countries just mentioned have special facilities for reducing the liquidity risk of depository lending for long-term mortgages. Such institutions do not attempt to provide full-term funding or to take over credit risk, but rather to resolve the basic intrinsic problem faced by depositories, that their liquidity can be compromised by lending for terms much longer than they borrow for. They are generally known as liquidity facilities or sometimes as **secondary mortgage facilities (SMF)** (as opposed to secondary mortgage markets (SMM) where loans are actually sold).

Each SMF operates somewhat differently. The American version of the SMF is the system of regional Federal Home Loan Banks (FHLBs). As noted above, despite their names, they are private entities owned by the banks which use them. They benefit by being sponsored by the government, but are also rated AAA because all of their loans are to banks and savings institutions who pledge mortgages with a market value of at least 120 percent of the amount they borrow, as well as the fact that they guarantee repayment. All of the credit risk remains with the bank, which must replace any loans which go into default.

The FHLBs issue all types of regular bonds based on their capital and the good collateral for their loans. They avoid taking any interest rate or liquidity risk in managing their portfolio of loans and bonds, but they are flexible enough to offer the banks a variety of terms on their loans that meet the general funding needs of the bank without having to match the terms of the mortgages. Thus, for example, a bank that needs USD 10 million for a loan to an auto dealer for two years can pledge 20-year mortgages (at marked-to market values) to secure the desired 2-year financing from the FHLB.

Such an institution is essentially a Housing Fund that makes loans against mortgage collateral instead of purchasing the mortgages. While the bank will need a reasonable deposit base, the existence of such a fund can be very comforting to an Hungarian bank with uncertain deposit funding and also would also allow the bank to choose between bond-market funding or deposit funding depending on the market conditions.

However, SMFs also face some difficulties. First, there is the general issue of whether bond-market financing will be more costly than deposits in general. Second, will the bond market view the credit risk of such an institution to be as low as a mortgage bank or government-guaranteed housing fund?

While not perfect, a liquidity facility such as this appears to be superior to either of the alternatives discussed. Since it looks to both the collateral of the mortgages and the guarantee of the bank, and the loans to the banks are overcollateralized, it should be as safe as or safer than a mortgage bank. This can make it almost as safe as a government-guaranteed housing fund that actually buys mortgages, without making it as unsafe for the government.

Also, from the point of view of the bank, even if the bond funding is generally more expensive than deposit funding, and thus mortgage banks would not prosper, this kind of facility would be desirable to have as a back-up for deposit based funding. For example, whereas normally a 50 basis point extra cost is too much to pay for permanent funding, paying it only when needed is inexpensive risk management. If in fact mortgage bonds are a cheap enough

source of financing for banks, SMF bonds could be used as permanent refinancing for mortgages, and the SMF should be able to give banks nearly as good access to those cheaper funds.

Lastly, the feasibility of an SMF does not force the issue of credit risk in Hungary. As long as a bank has enough loans in good standing that it can pledge as collateral, and assuming that good loans do not go bad too quickly, the SMF can operate as a very low risk borrower without a government guarantee. In contrast, a German-style mortgage bank or Fannie Mae-type Fund have only the mortgages they own as collateral for their bonds (unless the Fund has guarantees also from the originating lender). It is unclear how, short of a government guarantee, such entities can be very credit-worthy when OTP has trouble keeping its one-year delinquency rate below 5 percent and can not foreclose easily.

An SMF is not a panacea. In particular, it does not permit a bank to enter into retail housing lending without developing a retail deposit base or taking on significant credit risk. Nor will it necessarily work in the short run in Hungary, because it is not needed by OTP with its excess deposits and there are not many other lenders with loans to pledge. But it may be worth further consideration now because it is consistent with the set of institutions that Hungary will find useful eventually if it follows the trend in housing finance in most developed countries.

A MORTGAGE GUARANTEE INSTITUTION

It would be very desirable from the point of view of lenders for a government-sponsored entity to take over all or a major part of the risk of default or the job of recovery after default. Clearly, though, such a step raises many serious concerns, including the potential burden on the budget and the potential for political forces making the loan repayment environment worse in the long run due to weak enforcement. As noted above, other countries have dealt with the issue of residential loan recovery in different manners. A later paper will attempt to analyze these approaches and propose some lessons for Hungary in this regard.

It can be noted here, though, that it is not clear how developments in either funding or guaranteeing mortgages will change the housing loan situation substantially in Hungary. OTP already actively seeks to make housing loans. The terms and costs of these loans could be improved some through competition, but not substantially. One area that might make a difference would be the elimination of the requirements for guarantors or other collateral if there was a third party offering to guarantee the loan instead. However, elimination of such provisions would not be any more desirable for the guarantee institution than for OTP currently, unless other methods of assuring repayment were put into place. If such other methods were instituted, OTP itself would probably relax its requirements. Thus, the situation would be improved only if the guarantee institution has explicit or implicit powers not available to OTP.